Testimony of
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Before
The United States House of Representatives
Committee on Financial Services
Subcommittee on Housing and Community Opportunity
June 12, 2007

Good morning Chairman Waters, Ranking Member Biggert, and Members of the Subcommittee. I am Edward Connor, Deputy Assistant Administrator for Insurance within the Mitigation Directorate of the Department of Homeland Security's Federal Emergency Management Agency (FEMA). I appreciate the opportunity to appear today before the Subcommittee to discuss the National Flood Insurance Program (NFIP).

This morning I would like to provide a context for how the NFIP has moved forward since the devastating hurricane season of 2005. My testimony will address (a) the NFIP's financial status; (b) how the Bunning-Bereuter-Blumenauer Flood Insurance Reform Act of 2004 (Reform Act) has enabled the NFIP to operate more effectively; and (c) opportunities to fundamentally strengthen the NFIP's financial underpinnings.

The NFIP was established in 1968 to make affordable flood insurance available in communities that adopt and enforce measures to make future construction safer from flooding. From 1968 through 2004, a total of $15 billion was paid out to cover more than 1.3 million claims. From 1968 through 2004, the NFIP took in $20.5 billion in Earned Premium.

After the June 2004 signing of the Reform Act, the United States experienced back-to-back catastrophic hurricane seasons. The 2004 hurricane season resulted in over 75,000 claims totaling a record payment of over $2 billion dollars. That record fell in 2005 when Hurricane Katrina resulted in claims totaling over $16.3 billion to date – over eight times that of 2004 and exceeding, by over a billion dollars, the aggregate amount of all claims previously paid in the nearly 40-year history of the NFIP.

Last year David Maurstad, Assistant Administrator of FEMA's Mitigation Directorate, informed the House Financial Services Committee and the Senate Banking Committee that we expected the total NFIP payout (claims and associated expenses) for the 2005 hurricane events to be over $23 billion. We have reexamined that projection based on actual claims and payments to date, and lowered the estimate for claims payments, related adjustment expenses, and interest paid on borrowing to approximately $20 billion.

From 1986 until the 2005 hurricane season, the NFIP was self-supporting. During periods of high losses, consistent with the law the NFIP has borrowed from the U.S. Treasury. Prior to Hurricane Katrina, the Program had been in a debt position four times since the mid-1980s.

(1) After the 1993 Midwest Flood, the Program borrowed $11 million, and the loan was quickly repaid.

(2) Between 1995 and 1996, flood losses were twice as high as the historical average, and NFIP borrowing peaked at $922 million during fiscal year 1998. These monies were completely repaid by June 2001.

(3) In June 2001, Tropical Storm Allison required the Program to borrow $650 million, which was repaid by the end of October 2002.

(4) Between then and the 2004 hurricane season, the Fund balance grew to a positive $1.1 billion. However, the fund was exhausted after four hurricanes crossed Florida in 2004, forcing the Program to borrow $300 million. The repayment of this debt was on track but not completed before Hurricane Katrina struck.

The authority to borrow from the Treasury is an essential part of the NFIP's financing design by providing the necessary resources in those years where claims exceed premium pool levels. This authority enables the program to borrow limited amounts from the Treasury on occasions when income is not sufficient to cover claim payments and related costs. The loans from this period have been repaid, with interest, from policyholder premiums and related fees.

The large number of claims and severity of flood losses from the 2004 and 2005 hurricane seasons are unprecedented in the history of the NFIP. The challenges these storms have presented to the Mitigation Directorate, particularly the 2005 hurricane season – in terms of flood insurance claims handling, floodplain management, flood hazard mapping and mitigation planning and grants management – have never been encountered, on this scale, before.

However, Program claims have been resolved expeditiously. Only five months after Hurricanes Katrina, Rita, and Wilma struck the Gulf Coast, the NFIP resolved over 70 percent of the 241,000 claims filed from these events. By the summer of 2006, more than 98 percent of all Katrina and Rita flood insurance claims had been closed – a volume that far exceeded the highest number of claims filed from any single event in the NFIP's history, and more than triple the total number of claims filed in 2004. Given the circumstances, our industry partners – Write-Your-Own (WYO) insurance companies, as well as claims adjusters and agents – have more than fulfilled their responsibility to help NFIP policyholders begin to rebuild their lives.

In the wake of the worst natural disaster the Nation has ever experienced, we have continued to fulfill the promises made to NFIP policyholders and communities. FEMA is proud of the NFIP's ability to provide solid customer service to our flood insurance policyholders.

NFIP Financial Status

The extremely active 2004 and 2005 hurricane seasons raised the Nation's awareness of the flood risks we all face. This activity, along with NFIP marketing efforts, has resulted in dramatic NFIP growth over the past three years.

The NFIP has over 5.4 million policies for homes, businesses, and other non-residential property, insuring in excess of $1 ***trillion*** in assets, which represents an increase of 19 percent over the past 12 months. The NFIP now collects more than $2.5 billion annually in premiums and fees. As previously stated, from 1968 (the NFIP's inception) through 2004, the Program paid out $15 billion to cover more than 1.3 million claims. Many of these claims occurred as a result of smaller flood events that did not rise to the level of a Presidential disaster declaration and for which Federal disaster assistance was not available. Yet many of these property owners endured as much of an individual loss as those in larger events.

It is important to note that NFIP rate schemes are not designed to, in aggregate, cover catastrophic events or years, although the premiums for most properties already consider the potential for catastrophic losses. Over the years, the NFIP set premium levels to provide total program revenue covering the average, non-catastrophic loss year, plus expenses associated with administering the Program. Most of the NFIP's 2005 claims resulted from the damages caused by Hurricane Katrina, an event that has, and continues to, inform the NFIP, and that must be considered as we work to strengthen this important Program.

The NFIP provides insurance at actuarial (risk-based) rates for newer construction, with the majority of policyholders paying full actuarial rates, which consider the potential for catastrophic losses. However, statutorily, structures built prior to the mapping and implementation of NFIP floodplain management requirements are considered pre-Flood Insurance Rate Map (Pre-FIRM) buildings. Many Pre-FIRM buildings – which make up 24 percent of all NFIP policies – pay heavily discounted rates on the first $35,000 of their structure's insured value, and full risk-based rates for the remaining insured value. . Those Pre-FIRM building owners with discounted NFIP policies are paying, on average, only 40 percent of a full risk-based premium – while the NFIP considers the remaining 60 percent as forgone revenue – a loss that is ***not*** passed on to other NFIP policyholders.

How is it possible that NFIP maintained financial balance for so many years while heavily subsidizing such a large portion of its clients? Prior to Hurricane Katrina, although the NFIP had experienced heavy loss years, it had not experienced a rare, catastrophic flooding event. As a result, the Program's average historical loss year expectations significantly understated the actual long-term expected loss year.

About 75 percent of the NFIP's policy base consists of newer construction and buildings located outside the floodplain that pay full risk premiums. The remaining 25 percent of NFIP policyholders are charged much less than full-risk premiums. Before Katrina, the Program's total premium was sufficient to pay for the typical non-catastrophic loss year. If all policies had paid full premiums considering the potential for catastrophic losses, then the program would have built up a reserve in all those years in which catastrophes did not occur to at least partially cover the costs of Katrina.

Older, subsidized construction (built before 1974) was built at great risk to flood. Full-risk premiums for these buildings, on average, would be about five times greater than buildings that comply with current NFIP standards. The discounted rates charged to owners of pre-1974 buildings only cover about 40 percent of their full-risk

As stated earlier, we anticipate that total payouts for the 2005 hurricanes will be approximately $20 billion. To date, the NFIP has borrowed $17.535 billion to pay for Hurricane Katrina claims and for the interest payments due on that borrowing. A $2 billion borrowing authority bill passed Congress in early September 2005, and we have borrowed 11 times since . The most significant borrowing months were: $10 billion in November 2005; $1.775 billion in December 2005; $2 billion in January 2006; $2 billion in February 2006; $500 million in March 2006; and $400 million in October 2006.

Annual interest on the borrowing related to these payouts will be approximately $800 million. The 2005 flooding events were of a magnitude far beyond the ability of policyholder premiums to cover. Since Hurricane Katrina struck the Gulf Coast in August 2005, Congress has increased the NFIP's borrowing authority three times to the present limit of $ 20.775 billion. This additional borrowing authority has been a critical element of the NFIP's ability to fulfill the promise we made to our policyholders, allowing FEMA to resolve almost all of the Katrina, Rita, and Wilma claims received to date. However, under current loan obligation arrangements – with the NFIP needing new loans at least every six months to cover semi-annual interest payments – it is unlikely that the Program will ever be able to retire its debt without a significant adjustment to rates. Annual interest payments are expected to be $800 million to $900 million for the next few years. Assuming we can collect this as a non-premium fee, this would require about a 35 percent increase above the current NFIP written premium of $2.5 billion; which, in turn, would raise the average annual NFIP premium from approximately $480.00 to $650.00

The 2004 Reform Act and Effective NFIP Operations

In the aftermath of Katrina, the Reform Act proved to be instrumental in our ability to effectively inform and help Gulf Coast policyholders, and it continues to be a catalyst for programmatic success and improvement. We began implementing Reform Act changes during the 2004 hurricane season, and we have since improved our delivery by distributing informative materials to policyholders, implementing important training initiatives, adopting a flood insurance claims appeals rule, and carrying out initiatives that address repetitive loss properties.

<u>New Materials</u>

Increasing risk awareness among homeowners and consumers with improved, succinct information is one of the NFIP's basic principles, and is an important element of the Reform Act. FEMA, through an aggressive education and outreach campaign, is continuously designing and upgrading informational material to increase the public's awareness of flood risks and to effectively keep our policyholders informed.

For instance, as the Reform Act requires, FEMA distributes two informational documents, the ***NFIP Summary of Coverage*** and the ***Flood Insurance Claims Handbook*** to policyholders to help them through the claims process**.** These easy-to-understand materials, designed in concert with our insurance industry partners, are being distributed to all policyholders at the time of initial purchase, policy renewal, and at the time a claim is filed. Additionally, FEMA and the WYOs distribute these materials in our Joint Field Offices, Disaster Recovery Centers, and Flood Response Centers – as well as in Town Meetings – as soon as possible after storms strike. The ***NFIP Summary of Coverage*** and the ***Flood Insurance Claims Handbook*** have been invaluable additions to the Program and have played a major role in FEMA's ability to close claims quickly and fairly.

<u>Training of Agents Who Sell Flood Insurance</u>

Flood insurance training for insurance agents continues to be a high priority for the NFIP. Training requirements were published in the September 1, 2005 *Federal Register*, and we are working with the States as well as the insurance industry and related associations to inform insurance companies and agents of these requirements. To date, 40 States and the District of Columbia have issued bulletins making flood insurance training mandatory for agents who sell NFIP coverage.

We also are encouraged by the continued growth of classroom and online training participation. Since October 2006, the NFIP has conducted over 300 classroom workshops nationwide, which were attended by more than 11,000 agents. Also, FEMA's new on-line flood insurance training course has been well received. So far, over 15,000 insurance agents in 40 States have earned 3 hours of continuing education credit by completing the on-line training.

Of course, FEMA would like to see all of the States make flood insurance training mandatory for agents. We continue to encourage the States that already have minimum training and education criteria to place these requirements in their licensing and continuing education programs. FEMA is committed to providing technical assistance and resources to all the States as appropriate. One such resource is Agents.FloodSmart.gov. As part of our highly successful FloodSmart marketing campaign, this website provides extensive information for flood insurance agents, including links to educational and training programs.

Appeals Rule

FEMA's Flood Insurance Claims Appeals rule was published as an interim final rule in the October 13, 2006 *Federal Register*. This Reform Act requirement formalizes a process through which flood insurance policyholders may appeal the decisions of adjusters, agents, insurance companies, or FEMA, regarding claim settlements. The rule speaks to the issue of mediation, and we emphasize that mediation is most effective when it occurs early in the claims process. We are encouraging companies that sell flood insurance under the NFIP to make, or continue to make, this alternative dispute resolution option available to policyholders.

As the NFIP settles the last of the 2005 season flood claims, it is important to understand that the Program has maintained its historically high success rate of resolving over 99 percent of its claims without litigation. The NFIP's claims and appeals processes are based on a balance of power between the States and the Federal government. If State officials were conferred the authority to compel agents of the Federal government into the State's service, this balance could be upset, jeopardizing the NFIP's ability to close flood insurance claims quickly and fairly.

Currently, if a claim is denied, the insured may file an Appeal directly with FEMA. The ***Claims Insurance Handbook***, which is provided to all policyholders and claimants, includes detailed instructions on how to file that appeal. This allows the policyholder to go right to the source, the NFIP, to state their claims problem rather than turning to a third party such as a congressional office or state insurance commission. While assistance from those third parties can be helpful, it extends and further delays the claim resolution process. Creating a state mediation process would add another layer of delay, especially since the mediation would not be binding. Allowing the policyholder to work directly with FEMA in a Claims Appeal has been very beneficial to the claimant and is the best way to guarantee a prompt response and resolution.

Just as important, the NFIP is a federal program. The terms and conditions, including the insurance contract itself, are set by FEMA's Administrator. Such terms and conditions should not be subject to interpretation by state officials; therefore, FEMA opposes any provision which would require the NFIP to participate in state-sponsored mediation of flood insurance claims.

Addressing Repetitive Loss Properties

The Reform Act authorized a new $10 million Repetitive Flood Claims Program (RFC), which made the mitigation of repetitive flood loss properties a priority. Assistant Administrator Maurstad recently selected 41 RFC property acquisition proposals for further review, using all Repetitive Flood Claim Program funds for fiscal 2007. In FY2006, the first year of the Program, $9.8 million was awarded for property acquisitions.

Additionally, the Reform Act provided authority for increased funding under our existing Flood Mitigation Assistance Program, and I am pleased this Program's funding was increased to $31 million in Fiscal Year 2007, as opposed to $20 million in past years. Our 10 FEMA Regions are currently working with these funds, and the FMA application period has been extended to reflect the funding increase.

The Severe Repetitive Loss (SRL) Pilot Program, also authorized by the Reform Act, is in its final stages of development. In each of fiscal years 2006 and 2007, Congress authorized FEMA to transfer up to $40 million from the National Flood Insurance Fund to mitigate severe repetitive loss properties, which the Act defines as: properties that have experienced four or more flood losses of at least $5,000 each, with at least two claims payments occurring in a 10 year period, and with the total claims paid exceeding $20,000; or properties that have received at least two separate flood claims payments, where the cumulative flood claims payments exceed the value of the property. FEMA is developing the SRL program regulations, guidance and administrative documents necessary for implementation; and once the regulations are published in the Federal Register, FEMA will provide guidance to potential applicants. Multi-year funding is available to applicants during the first open application period, which we expect to begin this summer.

The President's budget for FY 2008 requested $80 million for the Severe Repetitive Loss program. A more robust SRL program is a critical component of FEMA's overall strategy to strengthen the National Flood Insurance Program (NFIP) that includes measures to reduce the nation's flood risk through floodplain management and improved flood hazard data; charging fair and actuarially sound premiums by phasing out subsidized premiums; increasing program participation incentives and improving enforcement where mandatory participation is warranted; increasing risk-awareness by improving information quality; and reducing future risks through a combination of mitigation measures and exploration of enhanced protective measures.

Since the majority of SRL properties were built before flood plain management regulations were established, they represent a disproportionate amount of losses in the NFIP relative to the subsidized premiums paid. SRL properties make up only 1 percent of all properties covered under the NFIP, but make up 20 percent of all claims. GAO findings confirm the need to reduce the number of subsidized premiums to strengthen the financial status of the NFIP:

> *"One reason the NFIP is not actuarially sound is because a number of its policies on dwellings built before flood plain management regulations were established in their communities are subsidized and pay premiums of 35-40 percent of the true risk premium.* Further, *In January 2006, FEMA estimated an annual shortfall of premium income of "$750 million because of such properties".*[1]

Increased investment in the SRL program provides a significant, long-term benefit to the NFIP. Savings realized by the reduction in SRL properties are realized year after year. The more rapid these properties can be mitigated, the greater the savings will be as not only will the number of flood losses be reduced, but the risk to life and property will also be reduced. Under the current FY 2007 funding levels for SRL ($40 M per year) and the Individual Repetitive Loss Program ($10 M per year), FEMA will be able to mitigate 1,500 properties that are currently incurring an average of $17.6 million in insured losses annually. Over ten years, the NFIP will have reduced loss payments by approximately $176 million, more than paying back the initial $100 million invested in these programs. And after twenty years, the reduction in loss payments will have grown to $352 million.

These mitigation tools will become critical components in our efforts to reduce repetitive loss structures and eliminate the flood-rebuild-flood cycle that residents in the Nation's flood-prone areas have become so familiar with.

Strengthening the Program

Significant flood events have played major roles in the NFIP's evolution: the Program was created after Hurricane Betsy carved a swath of destruction through the Gulf Coast in 1965; Tropical Storm Agnes in 1972 provided the impetus for the mandatory purchase requirements to increase participation in the program; and the 1993 Midwest Flood was the catalyst behind the National Flood Insurance Reform Act of 1994 and its stronger lender compliance requirements. It is entirely appropriate, therefore, that the catastrophic 2004-2005 hurricane seasons result in an examination of how the NFIP can be further strengthened.

Since the end of the 2005 hurricane season, in Congressional hearings and in presentations at various events nationwide, the Mitigation Directorate and the NFIP have outlined the following fundamental mitigation and insurance principles:

- Protect the NFIP's integrity by covering existing commitments;

- Phase out discounted premiums in order to charge policyholders fair and actuarially sound premiums;

- Increase NFIP participation incentives and improve enforcement of mandatory participation in the program;

- Increase risk-awareness among homeowners and consumers by improving information quality; and

- Reduce risk through combinations of proven mitigation practices and explore opportunities to reduce risks through enhanced protective measures.

The Administration strongly supports the concept in the bill of moving to actuarially sound premiums, but would prefer additional flexibility in the implementation of premium increases to allow an equitable transition to actuarial rates for all policyholders as quickly as possible. FEMA believes that H.R.1682, which is substantially similar to the previous bill from the 109th Session of Congress, is consistent with those principles because it:

- Provides authority to eliminate premium discounts over time for properties built before flood insurance rate maps were in place for non-primary residences;

- Increases the penalties for Federally-regulated lending institutions that do not comply with their mandatory purchase regulatory responsibilities;

- Requires a study of the feasibility and implications of expanding the standard for mandatory flood insurance purchase requirement to include properties in areas of residual risk – structures protected by levees, dams, and other manmade structures;

- Requires tenants to be notified of the availability of contents insurance; and

- Increases the annual limitation on premium increases.

The Administration recognizes the need to assess premiums that are fair and actuarially sound for all Federal flood insurance policyholders, not just commercial properties or non-primary residences. As written, the bill could exempt some pre-FIRM policyholders from having to pay actuarial rates.

We oppose the sections of the bill that would increase types of coverage and, Maximum Coverage Limits. As noted in last year's Statement of Administration Policy, increasing the coverage amounts could encourage expensive development in high-risk areas and should be rejected, especially given that total NFIP exposure already exceeds $1 trillion. In the same vein, the need for additional types of coverage is unclear without first studying the feasibility and cost implications of expanding coverage.

We also have constitutional concerns regarding a provision in the bill purporting to require FEMA claims adjustors to participate in State-sponsored mediation at the request of State insurance commissioners. The Constitution carefully allocates power between the branches of the Federal government, and between the States and the Federal government. This balance could be upset were Congress to confer on State officials the authority to compel agents of the Federal executive into the State's service.

Conclusion

The 2005 hurricane season presented the NFIP with numerous challenges on a variety of fronts and provided opportunities for fundamental structural reforms, as outlined above, that are critical to the financial viability of the program.

The proposed changes to the NFIP, when integrated into a comprehensive mitigation strategy, will improve the program's economic and financial viability. However, I want to emphasize that there is no quick solution that will enable the program to absorb catastrophic loss years.

I look forward to continuing to work with the Committee, our NFIP WYO companies, agent groups, and other partners to implement future changes to the National Flood Insurance Program, and I will be happy to answer any questions that the Subcommittee might have. Thank You.